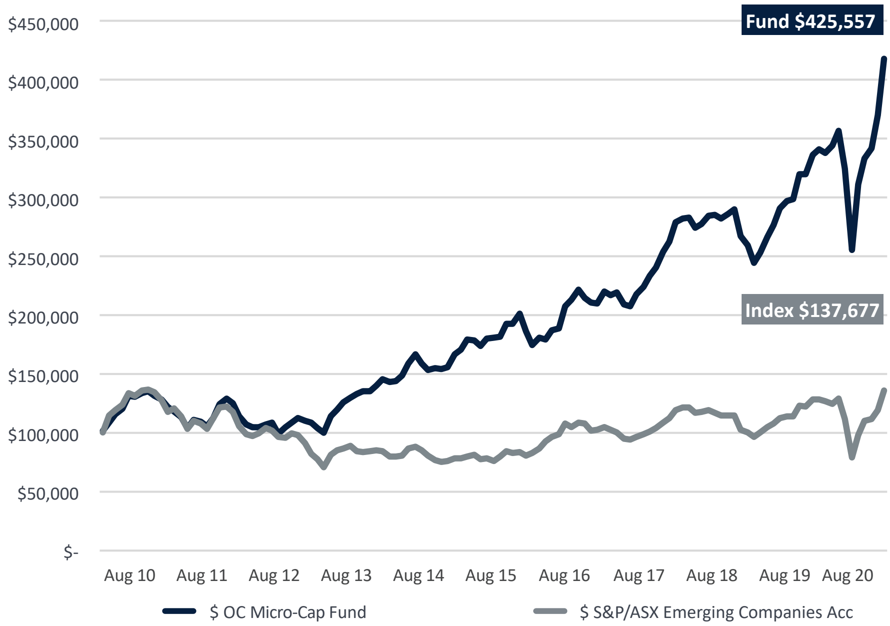
# OC Micro-Cap Fund
Fund Update | 31 August 2020

**13.1%** Fund up 13.1% for the month

**18.6%** Returned 18.6% p.a. for the past 5 years

We remain confident the Fund is well placed to deliver strong long-term returns

## Performance comparison of $100,000 over 10 years*




## Total returns

| At 31 August 2020† | 1 mth % | 3 mths % | 1 yr % | 3 yrs % p.a. | 5 yrs % p.a. | 7 yrs % p.a. | 10 yrs % p.a. | Incep. % p.a. (Mar 2003) |
|---|---|---|---|---|---|---|---|---|
| OC Micro-Cap | 13.1 | 25.9 | 31.4 | 21.8 | 18.6 | 20.0 | 15.6 | 14.9 |
| S&P/ASX Emerging Comp. Accum | 14.6 | 24.2 | 11.8 | 10.9 | 13.1 | 7.4 | 3.2 | NA |
| **Outperformance** | **-1.6** | **1.7** | **19.6** | **10.9** | **5.5** | **12.7** | **12.4** | **NA** |

Inception date for the Fund is 21/11/2003. Inception date for the Index is 31/12/2003. The performance reflects the performance of the OC Micro-Cap Fund since the change of strategy on 30 September 2016 and the performance of the OC Concentrated Equity Fund prior to that date. Performance is after fees applicable at the time. The total return performance figures quoted are historical, calculated using end-of-month hard-close mid-prices and do not allow for the effects of income tax or inflation.

## Performance review

The OC Micro-Cap Fund followed up its strong performance in July by rising a credible +13.1% during August. This was shaded by a very strong S&P/ASX Emerging Companies Accumulation Index return of +14.6%, with a host of the more speculative names in the Index, which the Fund typically avoids, helping to drive the outstanding benchmark return.

In the Fund itself core holding **Adairs Limited (ADH, +40.3%)** continued its ongoing re-rate after delivering an outstanding result which highlighted not only the resilience of its product offering over the difficult COVID-19 trading period, but also benefits of being a true omni-channel retailer given the structural changes we are seeing in the retail landscape. ADH itself generated $359.9m revenue, with online +61.4% year-on-year (YoY) and store like-for-like (LFL) sales -7.3%. Impressively, however, sales were up +3.9% excluding the store closure period. Momentum into FY21 remains very strong with July group sales up +32% YoY; Adairs online +106%; Adairs store LFLs +15.0% and Mocka sales +47.0%. Recently acquired online furniture business, Mocka, purchased in December 2019, performed exceptionally well in FY20 with revenue of NZ$48.8m, up +30% YoY.

The ADH online channels are delivering growth akin to pure e-commerce plays and dovetail nicely with the store network which continues to grow its profitability. While the trading multiple of ADH is beginning to re-rate, the stock still trades at a considerable discount to online peers. ADH has a very strong balance sheet with negligible debt and has a model that should be well positioned to weather any coming slowdown in retail sales once government stimulus measures inevitably end.

**Bigtincan Holdings (BTH, +39.5%)** is a provider of cloud-based digital sales enablement software to large enterprises with global and mobile sales forces. Sales enablement provides sales organisations with content, tools and information that assists their large sales teams by providing them with relevant content and training materials to streamline the buying process. The OC Micro-Cap Fund invested in BTH at a capital raise in May 2020.

BTH was up strongly for the month after reporting a solid result. Of note, Annual Recurring Revenue (ARR) grew +53% for FY20, of which organic growth delivered +42% ARR growth, continuing a recent track record of organic ARR growth. Despite the uncertain operating environment, BTH was also one of a few select companies to provide guidance for FY21. Given the stable recurring revenue nature of BTH and its track record of recurring revenue retention, BTH was able to give a robust outlook for continued organic revenue growth. Additional inorganic revenue growth is also likely given BTH has $71m of cash and a history of making targeted strategic acquisitions. We remain a holder of BTH and continue to back the execution of the BTH management team.

**Baby Bunting (BBN, +30.0%)** again rallied following the delivery of an outstanding full year result which demonstrated both the strength of the operating model in a challenging operating environment and the company's bona fides as a potential 'category killer' with a large competitive moat in the baby good space. Financial metrics were strong across the board with highlights including online sales growth (including Click and Collect) of +39.1% in the year which comprised +14.5% of total sales in FY20 (vs +11.8% in FY19) and also sales of higher margin private label/exclusive products which grew to 36.5% of sales, up 48% year on year. The sale of baby goods, including cots, prams, nursery furniture and babywear, has proven to be quite inelastic from a demand perspective and the online channel, including Click and Collect, has captured a good portion of any shortfall of in-store sales. It seems that BBN has taken further share from competitors in the COVID-19 lockdown with some remaining competitors (including Target which has announced store closures) suffering financial stress. Market share gains and excellent store profitability metrics has seen BBN lift its long-term store target to +100 (from its current 56 store network) and the company has flagged potential bricks and mortar entry into the NZ market, both of which ought to help the business sustain a solid long-term runway of growth.

**4DMedical (4DX; +103.4%)** was a blockbuster IPO for the Fund in August following hot on the heels of the Aroa Biosurgery IPO of July. 4DMedical is a medical technology company aiming to deliver the global gold standard in respiratory diagnostics for lung disorders including coronavirus, asthma, chronic obstructive pulmonary disease (COPD), cystic fibrosis and cancer. The unique technology accurately scans lung function as the patient breathes to provide early diagnosis and to monitor changes over time. The Software-as-a-Service (SaaS) scans deliver more complete results using lower levels of radiation than traditional methods. The investment team has met with 4DX several times in recent years as it advanced its technology and business model but it was not until the IPO stage that we were able to finally invest in the company within in our mandate restrictions. This extended period of engagement and research did, however, give us confidence that 4DX was progressing well against previously stated milestones and was highly likely to be a successful IPO well received by the broader market. The Fund is participating in further IPOs in September which we look forward to reporting on in our next monthly.

## Outlook

In the July Monthly Review, we commented that "*Many of the Fund's holdings have recently provided trading updates to the market meaning that the FY20 results are largely known*" and "*[W]e therefore do not expect too many earnings surprises in the August reporting season*". That fortunately provided to be largely accurate with result surprises for Fund holdings falling mostly on the positive side of the ledger. A combination of very good continuous disclosure from our companies in the months leading up to results and diligent analysis from our team meant that most of the uncertainty heading into results related to the outlook for trading into the new financial year. Again, this mostly surprised on the upside with outlook statements, where offered, generally better than expected, albeit frequently tempered by the well documented challenges facing the domestic and global economy brought about by the COVID-19 health crisis. Not unexpectedly, given the host of unknowns that remain, including the likelihood of further lockdowns, the duration of government stimulus and the success or otherwise of pivotal upcoming Stage 3 vaccines trials, the majority of listed companies chose not to offer numerical guidance into the new financial year.

Some of the more interesting observations from the micro-cap August reporting season include the following:

- Evidence of some of the structural trends accelerated by COVID-19 such as the acceleration of digitalisation and e-commerce were manifested in the FY20 results with beneficiaries, including Fund holdings **Adairs Limited**, **Marley Spoon Limited** and **Sezzle Limited**, each releasing strong results.
- Contrary to subdued investor expectations when the pandemic spread back in March, reporting season for the consumer discretionary sector was overwhelmingly positive, particularly for home related retailers (electronics, furniture, homewares etc). Government stimulus, coupled with lockdown restrictions limiting spending on usual options such as travel and entertainment, proved to be a boon for most listed retailers. Overall, they fared significantly better than smaller unlisted SMEs given many have omni-channel offerings and often faced less onerous

lockdown restrictions being deemed 'essential services'.

- Companies facing hard lockdown restrictions, on balance, preserved cash better than expected and many now have an extended liquidity runway having raised capital which ought to see them thrive in a lower competition environment once the pandemic passes. Companies such as **Capitol Health** and **Rhipe** each demonstrated outstanding cost control and are positioned to rebound strongly with diminished competition from unlisted competitors who lack access to funding to survive, or have been forced to significantly reduce their operations which could limit future growth.

From an economic perspective, central bank and government stimulus has thus far insulated us from the dire scenarios that seemed likely back in March. With campaigning for the US Federal election (scheduled for Tuesday 3 November) now in full swing, the world's biggest economy continues to surprise on the upside in terms of economic data. The unemployment rate has fallen to 8.4%, again exceeding consensus forecasts, and manufacturing and housing data continued to rebound, despite the second wave of COVID-19 cases still yet to be subdued. In a major policy shift, the US Federal Reserve has abandoned its policy of targeting inflation at 2% and will instead tolerate inflation modestly above this level in an effort to stimulate spending, employment and investment. This will likely mean lower interest rates for longer which ought to continue to be supportive of risk assets such as equities.

The Australian economy is officially in recession after the Australian Bureau of Statistics (ABS) revealed that June quarter GDP fell 7%, the biggest drop since records began in 1959. Despite this, the number was better than feared with an unprecedented raft of government stimulus and accommodative monetary policy from the RBA thus far warding off a more dire economic outcome, including the Treasury's own forecast which in March which contemplated a collapse in GDP of more than 20%.

The fortune of Australians, and Australian states, is very much divided at present with Victoria widely seen as the outlier. With the state now subject to a sustained second wave of COVID-19 infections, the Andrews' government 'health first' approach means Victoria has been subject to one of the strictest lockdowns globally, according to the Oxford University stringency index. This clearly has negative implications for businesses exposed to Victoria, particularly where they are not operating in 'essential services', and we have skewed our portfolio away from these companies accordingly.

The Federal government has extended (a diluted form of) JobKeeper wage subsidies until at least March 2021 and hinted that tax cuts worth $20 billion could be brought forward to help the nation's recovery from the pandemic. Fortunately, economic activity is slowly ramping back up across most of the country and our policy makers in Canberra are keen to encourage spending and job creation and our central bank, the RBA, "continues to consider how further monetary measures could support the recovery".

Growing hopes of a COVID-19 vaccine have certainly been supportive of strong equity markets over August and the US Centers for Disease Control and Prevention has gone so far as to ask US states to be ready to distribute a vaccine as early October. Some experts think it is even possible that a vaccine will be available ahead of the US election (in early November). There are now seven candidates in Phase 3 trials globally and several credible candidates have demonstrated a promising immune response in small scale, early trials.

Whilst an effective vaccine has been touted by some as a 'silver bullet' to the economic woes brought about by the pandemic, this is not likely to be immediately the case. A vaccine is most unlikely to be 100% effective, it must be manufactured on a mass scale and distribution of it will likely be, at least initially, limited; even if these challenges can be overcome many people are saying they will not take the vaccine fearing unknown side effects. Consequently, even if a vaccine is approved in the coming months, the range of potential economic outcomes is still broad which makes stock picking in this environment somewhat challenging.

With a host of unknowns and range of potential outcomes around a vaccine, portfolio management is no simple exercise. As a result, we are not putting all our eggs in the one basket and the Fund continues to hold a range of stocks (e.g. **Marley Spoon** and **Sezzle Limited**) that will continue to benefit from the structural shifts accelerated by the pandemic, as well as some recapitalised industry leaders (e.g. **Monash IVF Group** and **Viva Leisure Limited**) that will survive and prosper longer-term even if near-term vaccine efforts prove to be unsuccessful.

Fortunately, the Australian micro-cap index is a highly diversified stock universe that holds ample opportunity for stock pickers like us. Irrespective of the economic conditions there will still be stocks that perform well operationally, and we will seek out the ones that are trading below our internal valuations. We remain confident that we can continue to deliver our investors strong returns over the long term and thank you all for your ongoing support.

## Top 5 holdings#

| Company | ASX code |
|---|---|
| Adairs Limited | ADH |
| McPherson's Ltd | MCP |
| Rhipe Ltd | RHP |
| Sezzle Inc. | SZL |
| Viva Leisure Limited | VVA |

# The top 5 portfolio holdings are in alphabetical order and may not be representative of current or future investments.

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† The total return performance figures quoted are historical, calculated using hard-close end-of-month mid-prices and do not allow for the effects of income tax or inflation. Total returns assume the reinvestment of all distributions. The performance is quoted net of all fees and expenses. The index does not incur these costs. This information is provided for general comparative purposes.
* The performance comparison of $100,000 over 10 years is for illustrative purposes only. All returns shown are based on Australian dollar figures. Past performance is not a reliable indicator of future performance. The total returns shown are prepared on an ongoing basis (i.e. they include all ongoing fees and expenses and assume reinvestment of all distributions). They do not take personal taxation into account. The comparison with the S&P/ASX Emerging Companies Accumulation Index is for comparative purposes only. Index returns do not allow for transactional, management, operational or tax costs. An index is not managed and investors cannot invest directly in an index.